UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

MEMORANDUM FOR Marc Leland

From: Lionel H. Olmer

Subject: Papers on the External Debt Situation

Thank you for the recent paper prepared by your staff, in consultation with State, CEA and the Fed, on the Implications of the International Debt Servicing Problems for the International Financial System. This is a most comprehensive review of the problems in the global financial system. The paper gives good coverage of the roots of LDC and international financial problems, and points to the implications for global banking, finance, and international rescheduling mechanisms. As you point, out the present situation warrants close attention by governments because of the magnitudes involved and because it is likely to worsen if world economic growth does not resume in the near term.

The paper is an important step in determining how we as a government should react to these developments and possibilities. In preparation for the IG-IEP meeting tomorrow I asked my staff to review your paper and have attached our comments and suggestions. Generally they are of three types. First, they review and comment on the international financial and banking aspects of the problem which were covered in your paper. Second, we have attempted to broaden the scope of your paper by including an analysis of the trade impact of the liquidity problems which, as your paper suggests, could cause significant problems.

Having reviewed the first two sections of the paper we determined that the debt situation, even in a best case scenario, could have an enormous affect on U.S. economic, political and trade interests. Consequently, in the third section, while we agree with some of your policy proposals, we firmly believe these do not go far enough; therefore, we have added proposals which we feel are relevant to these broader issues.

My basic concern is that while an approach that deals with each country's situation on a case-by-case basis may avert an immediate crisis by meeting current liquidity needs, they would only avert a crisis temporarily. Banks and investors are becoming increasingly reluctant to continue lending to LDC's. The interbank market has contracted considerably and a tiering of bank borrowing rates has occured. All these things point to the lack of confidence being felt in financial markets despite multilateral attempts to stabilize the system.

On the trade side the effects have already been severe. Latin American imports of U.S. goods have shrunk 20% so far this year and adjustment policies imposed by the IMF or adopted by governments on their own will require further improvements in their trade accounts.

The requirements of IMF adjustment normally entail a contraction in a country's economy and any Balance of Payments deficit. Both of these steps initially translate into a contraction rather than an expansion of trade. Unfortunately these steps will have to be taken at a time when world trade is already contracting sharply and protectionist pressures are growing. Your paper nonetheless suggests that "succesful adjustment means essentially that the OECD area must accept a trade balance deterioration vis-a-vis the LDC area." This does not appear to consider the possibility that slow OECD growth and increasing protectionism may prevent the optimistic trade gains the LDC's project. In not meeting these objectives key LDC's may experience increased liquidity problems next year perpetuating the cycle of contraction.

In the U.S., the LDC's need to improve their trade account will come at a time when unemployment, a high dollar and increasing protectionism will create pressures to prevent a deterioration in our trade. The result could be severe for our trade policy in general and for the larger multi-lateral trading system. Even now we are faced with politically sensitive requests by Mexico and Brazil to prevent a reduction in access for their products. Next year's GSP renewal and attempts at a North-South trade round in the GATT could also be jeopardized. In addition, trade strategy and budgetary decisions (i.e. subsidies, Ex-Im funding) are now being made that may be counter-productive, or prevent us from making further attempts at allieviating strains in the international financial system through sound adjustment policies. If U.S. trade and/or economic policies are inconsistent with the steps needed to ensure a solvent international financial system, developments in the later may in turn force further contractions in trade and economic activity that could jeopardize U.S. and OECD recovery.

To assure that overall U.S. policy interests are assessed before deciding on an approach toward problems in the international financial system, the SIG-IEP should examine the financial, political, economic and trade impacts in much greater detail. In order to contribute to this process I am circulating the attached paper, prepared by ITA staff, to the IG-IEP members so they may review them before tomorrows IG meeting.

I. USDOC Comments on Implications of International Debt Servicing Problems for the International Financial System

- On balance this is the best and most comprehensive review of the global financial dilemma that we have seen. The paper gives fairly good coverage of the roots of the LDC and international financial problems, the implications of present strains for global finance and for the integrity of established rescheduling mechanism, and the implications for LDC economies and political institutions. Several sections (ID, IIB, IIIA) on U.S. and foreign bank behavior are especially well written and we concur with most of the views expressed.

- We are concerned that some of the assumptions used are overly optimistic. The baseline projections of 3 1/2% OECD GNP growth in 1983 contrasts sharply with recently revised OECD Secretariat projections of 1 3/4% growth. These revisions partly reflect changed assumptions about non-Opec LDC growth due to the debt problem. A low level of growth in the OECD could slow the increase in exports the LDC's will need to repay even generously rescheduled debt - and could cause an even more dangerous liquidity crunch next year.

- The paper mentions the possibility that net new lending by banks to non OPEC-LDC's in 1983 could decrease to $25 billion in a base case scenario or $0 in a worst case scenario. One can argue, however, that banks as a whole--led by U.S. and foreign "regional" banks--may actually try to reduce outstanding exposure in a crisis environment. In other words, it is conceivable that in the aggregate banks might attempt to run down their portfolios, especially short-term credit lines.

- A greater distinction should be made between the problem of dealing with the public-sector debt of key LDCs and debts of private sector companies and banks. In at least two critically important and troubled countries--Brazil and Mexico--private sector debts are large and may prove the most intractable. Indeed, LDC private sector defaults may have a much greater impact on bank balance sheets because possibilities for loss of principal--not just interest--are much greater. As economic adjustment occurs, governments will tend to allocate scarce hard currency to preserve public-sector creditworthiness, therby placing all others at the end of the foreign exchange que. Attempts by a country to nationalize private debt (i.e. Argentina) may also be counter-productive as bank regulations on country exposure, and customary trade finance relationships may exacerbate the problem.

- The likelihood of substantial losses on LDC private sector obligations is one reason we feel that the "worst case" scenario for bank losses (pp. 78-82) is much too optimistic. Also, it is unclear as to why principal repayments are excluded from this scenario. If a major debtor cannot remit interest, principal repayments could also be jeopardized. While it is possible that creative accounting, rescheduling, etc., will enable banks and bank regulators to "fudge" the issue of principal for a while, it is doubtful that this will reassure depositors, the general public, and interbank markets as to the quality of assets involved. (Particularly if bank disclosure increases in line with SEC proposals.) In short the problem may develop on the liability side as depositors move from these banks to other assets, further reducing the banks liquidity and perhaps threatening the solvency of major lending institutions.

- In this regard we are highly uncomfortable with the assertion on p. 80 (as well as elsewhere in the paper) that a major leakage of funds from the global banking system is not possible and/or not important because "deposits lost from one bank would be transferred to other banks and the banks receiving the funds would have to acquire assets." We are uncertain that this has been theoretically demonstrated, and it appears that there are substantial possibilities for flight into government securities, U.S. stocks, other high quality instruments, and physical assets. To a degree, this has already occurred in response to the relatively minor shocks experienced so far. Even if the system is indeed "closed", the practical impact of a major redistribution of lendable bank funds on industry and world trade could be highly disruptive.

- The section on lender-of-last-resort issues (pp. 91-93) is an important one yet it does not mention the Bank Ambrosiano affair. The actions of Italilan authorities in this case and the impact on the markets should be discussed and evaluated with an eye to possible future disruptions.

- Recently the Bank for International Settlements and Euromoney have noted sharp contractions in the inter-bank market and in the availability of lending to LDC's particularly Latin America. This data should be reviewed to re-estimate the impact on the debt situation. Also no mention is made of the deteriorating investment climate in many of these countries (Brazils foreign investment this year will be almost half what it was in 1980) which will contribute to their hard currency shortage.

- Further work should also be done on the implications of significant changes in the factors that underlie the major assumtions (i.e. oil prices, interest rates, exchange rates).

- Finally, one is left with the impression that there is relatively little that can be done to address one of the most critical dangers--i.e., that a growing "herd instinct" among bankers may result in severe, sustained cutbacks in international lending. The discussion of this problem makes no effort to distinguish between the behavior of "money center" and "regional" banks (both U.S. and foreign), whose motivations in international lending are quite different. While the paper acknowledges that the regionals may be very difficult to entice back into the market, the implications of this for syndicated balance-of-payments lending (as opposed to trade financing) are not spelled out. Our impression is that the regionals' withdrawal from syndicated lending may impair this vital financial channel for some time, because the expectation of poor "sell-downs" will increasingly deter large banks from underwriting and managing consortium loans. On this point, it would be useful to attempt quantification of the regionals' past role in international lending, especially their historical participation in loan syndications.

II. Trade Implicatons

The Treasury paper states that "succesful adjustment means essentially that the OECD area must accept a trade balance deterioration vis-a-vis the LDC area". This deterioration could have a significant impact on the U.S. economy, and U.S. trade policy. In order to put this in context it is necessary to review the importance of LDCs in U.S. trade.

- Developing countries are the largest growth markets for U.S. exports at a time when the U.S. economy increasingly relies on trade. The share of trade in U.S. GNP has doubled in ten years, and over 20 percent of U.S. industrial output is exported.
- Developing countries now receive 38 percent ($88.9 billion) of total U.S. exports. In 1981 the U.S. exported 19.5 percent more merchandise to developing countries than to the combined markets of Japan and the European Community.
- Last year U.S. firms sold $65 billion of manufactured products to LDC markets, over 40 percent of total U.S. manufactured exports, and more than was sold to Western Europe, Japan, and the communist countries combined.
- Over half of U.S. exports of general industrial machinery and electrical machinery went to LDCs last year.
- In 1981 when the volume of world trade dropped, U.S. exports to developing countries increased 9.6 percent. This compares to the 3.8 percent U.S. export increase to industrial countries.
- Latin America accounts for about half of U.S. exports to LDCs or nearly $40 billion in U.S. sales in 1981, Mexico alone accounted for $17.4 billion and was the third largest U.S. export market.
- The developing countries also account for about one-fourth of all outstanding U.S. foreign direct investment, or about $56 billion in 1981.
- U.S. firms have nearly $40 billion invested in Latin America, including over $8 billion in Brazil and almost $7 billion in Mexico.
- Almost 60 percent of the U.S. recovery of 1979-80 was a result of an improvement in the trade account. While that recovery came at a time when the dollar was weak the current position of the dollar will act as a drag on any export led recovery.

While LDC's are obviously an important market for the U.S. the increasing squeeze on their foreign exchange, exacerbated by rising debt-service obligations, will adversely affect their import capability. Already this process has begun. (See Table 1, for U.S. trade with major LDC debtors.)

- o In the first three quarters of 1982 total U.S. exports to Latin America have dropped 20 percent, and the $5.4 billion U.S. trade surplus with this region has already turned to a $500 million deficit.

- o Comparing January-August 1982 export data to the same period in 1981, U.S. exports to Mexico dropped 26 percent, to Argentina - 44 percent, Chile - 59 percent, Peru - 25 percent, and Thailand - 25 percent.

- o If bank lending remains flat Morgan Guaranty Trust Company projects a $30 billion trade reduction in Latin America alone. Mexico already plans cuts of $8 billion in imports, the U.S. share of which (70% of Mexican imports) could be as high as $6 billion.

- o In addition to causing a decline in U.S. exports, external debt problems may adversely affect U.S. foreign direct investors in these countries as capital, import and exchange controls may jeopardize their operations.

These factors affecting U.S. trade and other commercial relations will adversely impinge on U.S. economic recovery and particularly on employment.

- o The OECD Secretariat has now revised downward it's projection for 1982 & 1983 OECD-real GNP growth by 1/2% due to the contraction in non-OECD countries. 1983 OECD growth is now expected to be 1 3/4%. Japanese and European 1983 growth projections have been reduced by 3/4%, further reducing U.S.markets.

- o Recent estimates show that 23,000 jobs are created for every $1 billion in U.S. exports.

- o About one of every eight U.S workers in the manufacturing sector owes his job to exports.

- o Almost one-third of all U.S. corporate profits are derived from international activities, including foreign investments as well as trade.

- o The leading categories of U.S. exports to developing countries -- industrial and electrical machinery, chemicals, power generating equipment and aircraft -- likely are the imports that would be curtailed, thus injuring important sectors of the U.S. economy.

U.S. trade policymakers will find themselves between a rock and a hard place. The rock of reduced liquidity, contracting trade markets and the LDC's need to expand exports will meet the resistance of high unemployment and growing protectionism in the U.S.

- o The LDCs export push will impact the U.S. disproportionately as their devaluations and/or export subsidy programs add to the import surge that would follow from a high dollar and an expanding U.S. economy (even a 2% growth rate would be twice what the OECD projects for European economies).

- o Barter and other related trade arrangements not requiring foreign exchange could further undermine the multi-lateral trading environment. The U.S. may face export competitors willing to provide discounts on surplus or depressed goods that we also produce. Poland, Indonesia, Mexico, Venezuela, and Brazil have already begun discussing these techniques.

- o Investment requirements that are not beneficial to U.S. firms. For example, Mexico reportedly has offered international creditors of Mexican companies up to 15 percent in equity position in a Mexican company in lieu of an equivalent amount in debt repayments. Capital and import controls will jeopardize business operations and reduce incentives to invest, further reducing LDC capital flows.

- o The political sensitivity of these changes in trade flows and the resulting effect on trade policy could be particularly damaging next year. High unemployment, a large trade deficit and a more protectionist Congress could ruin any chance at GSP renewal, a North-South round of talks at the GATT, or any other trade expanding measures that may be needed to reflect the international financial situation.

- o U.S. Trade Strategy will have to be reviewed. Brazil has requested a two year extension on the promised phase out of their export subsidy program and we are concluding negotiations with Mexico that would allow them the injury test. At the same time these countries currencies may undergo further devaluations in order to spur exports. These changes will undoubtably create complaints that U.S. trade interests are being sacrificed for the benefit of "ungraduated" NICs and to rescue the loans of imprudent international banks.

- o <u>Other Latin American countries</u> whose debt problems will <u>affect U.S. trade include:</u> Argentina, Chile, the Dominican Republic, Costa Rica, Bolivia and Ecuador who have filed or are expected to file loan applications with the IMF. Already this year Haiti, Honduras, Barbados, Panama, El Salvador and Peru have obtained financial help from the fund. The common predicament among these nations is that their export earnings do not suffice to service their growing foreign debt.

- o <u>Without modifications</u> in our current strategy the <u>likelihood is that trade</u> policy and OECD growth will not allow the trade improvement LDCs need. Instead protectionist pressures will be inflamed, key LDC's will be unable to meet the stringent adjustment policies needed for IMF and bank lending, liquidity will contract further and 1983 will produce and even more destabilizing round of crisis borrowing.

III. Treasury Policy Proposals

- The policy proposal to increase IMF lending is an important step in providing the resources needed to avert a financial crisis. The quota increase, coupled with the new borrowing arrangement proposal and the speed up of the timing for the implementing of the quota increases, all indicate appropriate concern for the seriousness of the problem. However, the decision to limit access to the quota increase and to put emphasis on meeting emergency needs reaffirms our concern that trade impacts are being ignored.

- The other steps that might be taken to assist balance of payments adjustment are mentioned but are usually rejected quickly as insufficient to meet an acute crisis. However, these steps used in an integrated manner may provide the funds needed to assure that the adjustment policies to not severly disrupt trade flows or set off counterproductive protectionist policies. For example:

  -- Expansion of ESF facililty. After admitting that the "greatest potential" for USG balance of payments assistance to LDCs lies with the ESF (p. 88), the paper devotes only two more sentences to this alternative. What are the pros and cons of seeking supplemental appropriations earmarked for extraordinary economic/financial emergencies where U.S. economic, commercial, or national security interests might be threatened? To lessen the budgetary impact, could increases in ESF funds to a given country be subtracted from funds committed to that country under military assistance programs in situations where economic dangers supersede military dangers as a threat to security.

  -- P.L. 480. Again, the paper devotes only two sentences to this option (p. 88). Is it feasible or desirable to seek legislative changes to expand the program and/or the number of countries eligible? Would the current malaise in the U.S. farm sector make it more desirable and/or feasible to attempt this? Could the increase costs be partly offset, e.g., through reductions in agricultural stockpiles, and storage costs?

  -- CCC. The paper notes that "Congress enters the picture only when there is a need to increase CCC's borrowing limit" (p. 89). Precisely how close are we to that limit, and which of the major problem countries would benefit most from CCC guarantees?

-- Exim. The argument that Exim should not provide "balance of payments" support (p. 90) should not necessarily preclude emergency financing (e.g., via increased short or medium term loans or guarantees) in order to preserve some trade financing channels in a payment crisis. In fact EX-IM bank has authorized "Emergency Foreign Credit Loans" precisely to help countries such as England, Canada, and Italy in sudden BOP crisis. Although EX-IM has not authorized such loans in recent years there has been no change in EX-IM legislation that would prevent the bank from doing so again. Apart from assisting U.S. exporters such action could, in combination with other assistance, help maintain minimum levels of vital trade and cushion LDC economic disruption during and after economic adjustment and rescheduling. Also, by providing a measure of stability on the trade scene, the prospects for unbridled fear and panic on the part of banks and suppliers would be reduced.

The final Treasury section on extrordinary policy reponses does not seriously review any option. Rather, the approach used is to set up "straw men" and quickly reject options which might require departures from past practice, a re-examination of USG policy priorities, and/or legislative action. This bias implicitly tends to discount the possibility that the problem, is, or may become sufficiently serious to justify new tactics. While the proposals as stated go beyond the bounds of good polilcy, if we continue to make no attempt to respond before each crisis becomes apparent, the likelihood of having to resort to these extraordinary measures will inrease. In that case we will be forced to seriously consider these extraordinary measures.

USDOC Suggestions for IG Consideration

Although the unprecedented scale of LDC financial difficulties is acknowledged throughout the Treasury paper, this recognition is not reflected in the policy section via an objective and thorough analysis of all possibilities for dealing with the problem.

The policy discussion tends to only mention the immediately available options in dealing with the liquidity problem. It makes no firm proposals as to what measures or group of measures should be implemented. The IG-IEP, after reviewing the scope of the problem, should analayze the entire range of options available and make recommendations to the SIG. Until that time we are left with the current ad-hoc crisis approach to each country when their emergency has become apparent to all. This approach involves IMF leadership with temporary bridging funds arranged by the U.S., the BIS or commercial banks.

While this policy is useful in that it impresses upon a country the need to take steps to adjust their economy to the crisis at hand it only goes part way in to stabilizing the international financial environment and may not be an efficient use of resources. We are increasingly concerned that this approach coupled with a pull back in bank lending will impose such a constraint on liquidity that international trade will continue to contract. This will not only affect U.S. trade and economic activity but it may perpetuate a cycle of trade and economic contraction worldwide. This in turn will prevent LDCs from earning their way out of these debt burdens and could result in rampant protectionism, an increasingly worsening debt situation and international economic problems of perhaps unmanageable proportions.

As we have mentioned, this situation may be exacerbated by changes in U.S. trade policy. Consequently the policy proposals should outline the steps needed to insure that financial, economic and trade problems are examined so that progress made in one area is not inconsistent or frustrated by action in a related area. In reviewing proposals advanced thus far, none seem to address these broader issues in an integrated fashion. The IMF proposals take a first step in resolving the liquidity problem. However, if a broader use of the IMF is seen as more appropriate suggestions along the following lines should be reviewed.

- Limiting access to the new quota increases to the current dollar amounts provides little in the way of new liquidity despite the fund increase. Only in crisis situatons would additional monies become available, and as these funds are tied to economic adjustment programs that typically require contractions in economic activity and imports, they would contribute to world trade tensions.

- While not suggesting that IMF conditionality be relaxed, a more realistic, long range adjustment program ~~would be~~ more appropriate at a time when world-wide contractions in trade and economic activity are threatening the viability of the post-war international trade and financial system.

- IMF funds still tied to conditionality, that are available in larger amounts before a liquidity crisis is flashed across financial pages world-wide, would go far in stabilizing international financial and trade markets. Banks would have more confidence in the long term outlooks and LDC trade, while adjusting, would do so at a rate that would not darken the economic outlook thus further speeding LDC balance of payments recovery.

- Closer cooperation between the IMF and GATT would be another important step in insuring that balance of payments adjustments could be carried out in a way that does not destablize world trade. In fact it could provide a way to improve trade relations. OECD market liberalization could be linked to the phase out of the import regimes, export subsidy programs and exchange rate controls which are a target of IMF conditionality.

- o Closer IMF and commercial bank cooperation could insure that IMF lending does not simply replace private lending. Co-financing is apparently already being discussed at the IMF and could be used to prevent the pull-out of banks that only increase the demand on IMF resources. IMF and bank cooperation during reschedulings might insure that a realistic and coherent financial plan was established so that solutions might be found rather than merely the postponement of problems.

- o Closer multi-laterally cooperation that links trade and financial policy changes could be used to assure that the crisis in finance does not feed the contraction in trade and vice versa. LDCs would then be in a better position to earn their way out of debt through trade expansion rather then import contraction.

Broadening the role of the IMF should only be a first step in moving toward a more integrated approach to the LDC debt problem. The IG-IEP should begin to develop these and other proposals that address overall U.S. interests. The IMF is only one tool we can use in this regard. Debt problems and their implications will surely grow. The U.S. will not have the resources to handle each country's problem on a case-by-case basis. Consequently, the IG should seriously review all other proposals now so we can be prepared to move before events force inappropriate actions. Increasing protectionism, stagnant economies, and North-South trade tensions increase the need for prompt positive actions.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

October 20, 1982

MEMORANDUM FOR BERYL SPRINKEL
UNDERSECRETARY FOR MONETARY AFFAIRS
DEPARTMENT OF THE TREASURY

FROM: PAUL KRUGMAN
INTERNATIONAL ECONOMIST

Subject: Draft Interagency Study on International Debt

Chairman Feldstein has asked me to send you the attached comments on the debt study. These are my own comments; however, he has read and concurs with them.

Attachment

cc:
Marc Leland
Thomas Leddy

DRAFT INTERAGENCY STUDY ON INTERNATIONAL DEBT: COMMENTS

The study is a useful compendium of facts and analysis, but it is still lacking as a guide for policy. There is a lack of continuity between the overview, which gives a reasonably clear and concise view of the problem, and the body of the study, which often seems to lose the thread. More important, both the overview and the body of the study trail off and become vague when the discussion turns from description to policy analysis.

The central feature of the current situation, in CEA's view, is the fairly abrupt loss of confidence by banks. Each bank would like to reduce its LDC exposure; but their collective attempt to do this imposes an impossible cash flow problem on debtor countries. The critical nature of this problem is recognized in the overview, but not so well treated in the body of the study. There is too much emphasis in the study on the risk of a loss in confidence <u>in</u> the banks -- which may be tomorrow's problem -- and not enough on the loss of confidence <u>by</u> the banks, which has already happened. Some chapters seem to imply that the present situation is sustainable because there is no sign of a run on the banks. This is unfortunately not true. The present situation is unsustainable even if public confidence in banks holds firm.

In order to reduce banks' exposure as fast as the banks are implicitly demanding, the major debtor countries would have to suddenly move from sizeable current account deficits to huge current account surpluses in the face of a depressed world economy. This will not happen. What will happen is one of three things: (i) austerity programs in debtor countries will restore lender confidence and the cash flow problem will ease; (ii) debt payments -- principal and a good deal of interest -- will be rescheduled in an orderly way; or (iii) payments will be rescheduled in a disorderly way, as debtors stop payment or even repudiate their debt. We would like to see (i) happen, but we can't count on it. We should have a plan to insure that the alternative is (ii), not (iii). The study gives us little guidance on how to do this -- particularly on how to do this without creating dangerous problems of "moral hazard" for future bank lending.

More specific comments:

<u>I.C.</u> (Illustrative financing patterns): The "freeze on bank lending" numbers are meant to show a sort of worst case, but they do not do this very well, for two reasons: (i) zero net lending is not a floor -- banks could demand repayment of principal as well as interest; (ii) an aggregated table like this makes a zero net lending scenario look possible, while a disaggregated look would show that it isn't. The countries

with high debt-export ratios -- precisely the ones most likely be unable to borrow -- would be forced to contract imports by huge percentages to pay all interest out of current earnings.

I.D. (Willingness and ability): An obvious point: the data here is all from before the Mexican crisis and thus does not reflect the full extent of the current crunch.

II.C. (Debt servicing problems): This chapter seems not to reflect the realities of the current situation. The statement on p. 57 that "despite the debt shocks...the international system remains intact" sounds a bit like the man who jumped off the top of the Empire State Building and was still in fine shape as he passed the 10th floor.

III. (Sensitivity): Chapters A and B of this seem to view a bank crisis as the primary worry, without giving sufficient weight to the threat of the cash flow crisis for borrowers even while banks retain the confidence of their depositors. Chapter C does not discuss the probability of a moratorium on debt service or debt repudiation as a political outcome of "narrow, inward-looking nationalism."

IV. (Policy Responses): This whole section never responds to what CEA sees as the central problem: How can the cash flow problem of LDCs be eased, if that becomes necessary, without letting banks and governments "off the hook" in a way which will encourage irresponsible behavior in the future?

NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

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November 24, 1982

MEMORANDUM FOR THE HONORABLE MARC LELAND
Assistant Secretary for International Affairs
Department of the Treasury

SUBJECT: Comments on Debt Paper

We congratulate the Treasury staff on an excellent paper on the implications of the current debt situation. We would, however, have the following comments:

1. Although we understand the argument that a posture of confidence toward the public may be useful to avoid panic, we do not believe such a posture is useful within the government. A systemic financial crisis is entirely possible in the near future, and even if it is avoided in the near term, the danger will remain for some time. The fact that the government came to a realization of the problem very late does not mean that false optimism should be maintained.

2. There seems to be a contradiction between the statement on page one that LDC adjustment will have a contractionary effect on world output, with which we agree, and the statement on page two that a drop in world economic activity is unlikely.

3. We have no doubt that a crisis would require massive intervention by the governments and central banks of industrial countries as stated on page two. We also do not doubt that it would take place. There is no reason to believe that the mistakes of the 1930's would be repeated. Nevertheless, the trillion dollar Euromarket is a factor that did not exist in the 1930's and it is not clear that central bank injections of liquidity into domestic financial markets would to any extent be used to fund the Euromarket. Is it not more likely that the additional liquidity would be seen by the banks as an opportunity to eagerly take payments on their Euro-interbank deposits rather than roll them over -- hence neutralizing the effects of the capital injection.

4. It is true that ad hoc measures may be sufficient to head off the most serious problems, as stated on page two. However, the operative question is for how long, and what will be done in the medium-term to deal with systemic malfunction?

5. On page 6, the statement that withdrawals by non-banks from an individual bank will not bring about a real loss of funds to the banking system since deposits lost by any one bank will

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be redeposited elsewhere is true but misleading because it is a straw man. The real questions are: To what extent will lending be diverted from international to domestic lending or other purposes, and what will maintain the liquidity of the Euromarkets?

6. It would be helpful to give some idea on page 15 of what is meant by the statement that some modifications in the Paris Club approach may have to be considered.

7. It might be advisable to modify the statement about the effects of relaxation of IMF conditionality at the bottom of page 17 with something about the trade effects of conditionality.

8. On page 91 of the Baseline Projections, it is stated that there may be practical problems in distinguishing liquidity from solvency problems in some cases. It is not clear what this means. Why should there be any problem?

9. The last sentence of page A-15 is incorrect. Ecuador, Iraq and Indonesia are OPEC countries which are also having difficulties in servicing their debts.

N Bailey

Norman A. Bailey
Senior Director
National Security Planning

Roger W. Robinson

Roger W. Robinson
Staff Member

cc: William P. Clark

OFFICE OF THE UNITED STATES
TRADE REPRESENTATIVE
EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON
20506

December 14, 1982

MEMORANDUM FOR MARC LELAND
TREASURY DEPARTMENT

FROM GEZA FEKETEKUTY

SUBJECT COMMENTS ON LDC DEBT PAPER

The U.S. Treasury draft paper, Implications of the International Debt Servicing Problems for the International Financial System, presents a thorough and excellent review of the international financial problems resulting from current LDC balance-of-payment difficulties. It has been a most informative and useful input into considerations of the implications of the current financial crisis for U.S. trade policy underway at the U.S. Trade Representative's office and throughout the USG's trade policy community.

Rather than address the analysis already contained in the Treasury's draft paper, these comments concentrate on considerations for U.S. trade policy which were not fleshed out in the draft paper. For your information, a draft paper by USTR staff is attached. Although limited to estimating some of the impacts of the LDC debt problem on U.S. trade, it is nevertheless suggestive of our trade policy concerns and the desirability of an integrated finance and trade approach to the current problems.

We consider the trade policy discussion to be of particular importance in the current policy debate surrounding LDC and global balance-of-payments disequilibria. Developing country financial problems will have a direct effect on the U.S. trade balance and economy. In addition, many of the instruments open to the LDCs in dealing with these deficits are commercial policies; how the LDCs choose to employ these instruments may have an important impact on the future of recent protectionist trends in the world economy.

The Treasury draft focuses on the question of the threat to the international financial system and concludes that sufficient resiliency exists to avoid a crisis. Nonetheless, even in survival the system will impose financial stringencies upon the debtor countries that in the end must be dealt with primarily through their trade sectors. Some necessary combination of import-restricting and export-promoting measures to improve LDC current account positions are a matter of concern to trade policy. What matters especially in this respect is not just the extent of the expansion of LDC net exports, but the types of trade measures taken to achieve that expansion.

In formulating U.S. policy a coordinated approach is needed to assure that financial and trade policy decisions do not work at cross purposes. The twin goals should be to protect the stability of the financial system and to minimize the disruption to world trade in general and U.S. trade in particular. At stake is more than the desirability of limiting transitional trade strains during a period of balance-of-payments adjustment by the LDCs. Longer term, the efforts of many years of U.S. encouragement to trade liberalization by LDCs and to their fuller acceptance of the rules of the international trading systems may be at stake. At home, evidence of further deterioration of the global trade picture through increased LDC protectionism would make domestic protectionist pressures all the more difficult to deal with. The search for a cure to the ills of the international financial system should be explicitly coordinated with our efforts to safeguard the integrity of the world trading system. The current situation may furthermore offer substantial opportunity for such coordination: as private bank lending to LDCs declines relative to official and multilateral financing, there is likely to be increased leverage to negotiate limitations on the expansion of the most distortive LDC trade measures.

Efforts are underway within the Trade Policy Staff Committee to define and develop responses to the most important trade policy questions arising from the current LDC debt crisis. Illustrative of the type of trade issues under consideration are the following:

-- Among the trade measures available to the high-debt LDCs in reducing their trade account deficit, which measures should the United States encourage or tolerate and which measures should we actively oppose?

-- How should the USG respond to likely requests by individual, high-debt LDCs for special preferential treatment in the U.S. market?

-- Is special coordination needed among OECD members to ensure that there is equitable burden sharing in the developed countries' responses to the increased export push and import contraction by LDCs?

cc: J. Lister

Department of Agriculture

(iii) CCC - Agricultural export credit guarantees available through the Commodity Credit Corporation in FY 1982 totalled $2.5 billion. For FY 83, OMB authorized an increase to $2.8 billion. In August 1982, however, Agriculture Secretary Block agreed to allocate $1 billion of the FY 83 guarantees to Mexico and OMB increased the level of credit guarantees to $3.8 billion. The additional $1 billion is part of the emergency support package for Mexico assembled by the U.S. Government.

In general, there is considerable flexibility in programming CCC-guarantees. 1/ USDA sets the annual CCC guarantee level with the approval of OMB. Congress enters the picture only to either replenish CCC's losses or increase its borrowing limit through the appropriations process.

1/ The U.S. Department of Agriculture strongly objects to use of CCC export credit programs for purposes of political and/or economic support. CCC is a Government-owned and operated corporation. It was created to stabilize, support, and protect farm income and prices. Export credit programs administered by CCC help to meet this objective.

CCC's export credit guarantee program (GSM-102) is designed to expand U.S. agricultural exports by stimulating private U.S. financing of foreign purchases on credit terms of up to three years. The program operates in cases where credit is necessary to increase or maintain U.S. exports to a foreign market and where private financial institutions would be unwilling to provide the financing without CCC's guarantee. It was not intended that GSM-102 be used to give a country political or economic support.

Each request received for GSM-102 financing is examined from the point of view of whether it will result in additional sales and if there is a reasonable expectation repayment will be forthcoming along a commercially supportable payment schedule. The program is designed to use guarantees as contingent liabilities to support commercial agricultural exports while not expanding Federal outlays. As risk exposure increases, outlays will increase and the basis for the program's ability to operate through the commercial banking system will erode.

Maintaining the Corporation's financial integrity is implicit in the 1948 law establishing CCC as a Federal corporation within the U.S. Department of Agriculture. All members of CCC's Board of Directors and the Corporation's officers are officials of the U.S. Department of Agriculture. Using CCC's export credit programs other than as authorized in the CCC Charter Act is a violation of law and is a manifestation of irresponsibility by Government officials.

Comments Provided by Department of Defense
(Ray Lombardi, tel.: 697-5336)

Final Paragraph in Section IV (A)(2)(a)(ii)

Revise as follows:

In general military assistance is not well suited for inclusion in a financial assistance package. It is an important specialized policy tool, useful, based on its own merits, in a limited number of countries where there is a demonstrated policy need and where the U.S.M. has strong political-military interests. In FY 82, only seven countries received more than $100 million (Israel, Egypt, Turkey, Korea, Sudan, Spain, and Greece).

The underlined passages denote the changes.

Typed by:

Treasury/IMB
12/21/82